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SUBJECT: ARMENIA'S GROWING INSURANCE SECTOR

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SUMMARY

¶1. Despite the rapid growth of Armenia's banking sector and GDP over the past several years, other financial services, including insurance, have developed more slowly. Insurance remains a small part of the financial sector and plays a minor role in financial intermediation. Encouragingly, the transfer of insurance supervisory authority to the Central Bank of Armenia (CBA), adoption of new insurance legislation, and rising incomes may ultimately lead to a more rapid development of this sector. End Summary.

SMALL MARKET SIZE

¶2. The Armenian insurance market is quite small, even for a country of its size. Annual revenue from insurance premiums currently equals about AMD 5.124 billion (USD 14.12 million), with AMD 3.078 billion (USD 8.48 million) -- or 60% of premium income -- transferred to reinsurance firms. Due to the use of non-proportional reinsurance, 95% of the insurance risk is reinsured. This constitutes "fronting," a practice generally discouraged by insurance regulators by the imposition of minimum retention requirements. This also has the effect of making insurance companies brokers rather than insurers. Insurance penetration -- insurance premiums as a percentage of GDP -- is currently 0.22 percent of GDP, compared to 9.2 percent in industrialized countries, 2.7 percent in Central and Eastern Europe and 0.5 percent in neighboring Georgia. Despite the small market size, limited demand and limited range of products offered, insurers in Armenia are profitable due to low loss ratios (claims). Their total assets currently amount to 8.15 billion drams (USD 22.45 million), with total equity capital of 5.526 billion drams (USD 15.22 million). (COMMENT: All figures in this report are based on year-end 2006, which is the last year for which there is complete data. Figures are based on the exchange rate on December 31, 2006 (AMD 363 = USD 1). The statements in USD would now be approximately 20% higher, due to the appreciation of AMD against the USD.)

¶3. As of November 2007, there were nine insurance companies and six brokerages operating in Armenia, down from 26 and 9, respectively, since the beginning of 2006. This consolidation has occurred primarily due to stricter controls imposed by the CBA, in particular minimum capital requirements, that have forced smaller firms from the industry. In the last three years the minimum capital requirement has tripled to AMD 350 million (approximately USD 1 million) and on January 1, 2008 will increase to AMD 500 million (approximately USD 1.5 million). This change should result in a further consolidation of the market, leaving a small group of well-capitalized insurance providers.

¶4. There are no restrictions against foreign investment in Armenia's

insurance sector, and the CBA Chairman has repeatedly emphasized his willingness to attract leading multinational insurance groups to Armenia. At present there are three foreign-owned firms in the market: Cascade Insurance, owned by US based Kafesjian Family Foundation; London-Yerevan Insurance, a full subsidiary of UK-based Golden Gate Investment and Management company; and INGO Armenia, majority shareholder Russian Ingostrakh. According to CBA officials, companies from Germany, Ukraine and Russia have expressed interest in establishing subsidiaries in Armenia. Speaking at a recent business forum in Brussels, Armenian President Robert Kocharian expressed hope that German and French insurance companies will start operating in the Armenian market by the end of the year. According to media reports, HSBC-Armenia Bank has also declared its intention to establish an insurance company in the country. Armenian officials have also approached U.S. Embassy officials in the past to request help in attracting American insurance firms into the Armenian market.

¶5. After two unsuccessful incarnations, a newly formed trade group, The Association of Insurers, began to play a modest role in the sector after its formation this year. Although the Association cooperated with the CBA in drafting the new regulations for the sector, it lacks both financial and human resources to be fully effective.

LIMITED PRODUCTS OFFERED

¶6. The number of insurance products available in the Armenian market is very limited. The main types of policies available are vehicle (collision and non-mandatory third-party liability), property, cargo transportation, as well as travelers' accident insurance. With the development of the mortgage and consumer loan markets, the volume of property insurance has increased considerably, as most banks require property insurance in order to provide loans.

¶7. The market for conventional life insurance is virtually

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non-existent. In the past it generated only USD 90,000 in premiums, less than one percent of the total. Under the new Law on Insurance, which took effect October 1, 2007, firms are prohibited from offering both life and non-life insurance. While this constraint can be accommodated by establishing another subsidiary, the high capitalization requirements relative to the potential premiums to be generated prevent life insurance from being a cost-effective market segment at present. Generally, the lack of investment opportunities -- particularly long-term opportunities -- in Armenia makes development of the life insurance market difficult, if not impossible.

EMBASSY CAUGHT IN THE SQUEEZE OF TRANSITION

¶8. The Embassy has inadvertently found itself a victim of the changes in the domestic insurance industry. As a result of the new law, Cascade Insurance, which had provided both health and life insurance for the Embassy's LES employees, was forced to discontinue providing life insurance (rather than discontinue the more lucrative health insurance), effective December 1, 2007. As a result, the Embassy is currently in the unenviable position of having to self-insure, while it seeks another insurance provider that can provide the same level of service and protection it previously enjoyed.

WHAT'S THIS "INSURANCE?"

¶9. One of the factors behind the small insurance market is the absence of a so-called "insurance culture" in this society. Insurance is a relatively new, private market concept not employed in the Soviet era, and not well understood in Armenia. With little experience with these products, public skepticism is high regarding

whether insurers will pay claims. Insurance is also something of a middle-class concept, and many who struggle to meet current expenses do not feel they can afford the "luxury" of spending money to protect themselves against potential future calamities. Others simply do not see the need to spend today to protect themselves tomorrow. According to one firm, many clients who sign up for auto insurance as a requirement for receiving a car loan cancel their policies as soon as their loan is paid off, even if they will receive a very small refund.

AREAS FOR GROWTH

¶10. Aviation is the largest insurance category, comprising nearly half of total industry revenues; in effect, Russian-owned INGO Armenia, the company that holds the contract to insure Armavia (the privately-owned national airline), is the country's largest insurer.

¶11. Nevertheless, the strongest growth is currently occurring in the health insurance market, as large employers -- both foreign and local -- are beginning to provide health coverage as an employment benefit. With the implementation of pension reform in Armenia, which will allow the introduction of private pension schemes, the life insurance market may receive a further boost. Another major growth area is expected to come with third-party liability motor insurance, which is expected to become mandatory at the beginning of ¶2009.

CENTRAL BANK IMPROVES SUPERVISION

¶12. In a move that most insurance companies consider a positive change, on January 1, 2006, the highly-regarded CBA assumed the role of unified regulator and supervisor of Armenia's entire financial sector, including the insurance sector, thus becoming the sole authority to license and supervise insurance and reinsurance activities. Though insurance supervisory authority previously belonged to the Insurance Inspectorate of the Ministry of Finance and Economy, the primary motivation for a single supervisory authority was to oversee general risks across the financial market. The CBA may be in a better position to supervise and regulate the insurance sector, as it has broader experience in financial sector regulation and greater institutional capacity. The CBA will also play an important role in the near future by enforcing the new Law on Insurance, enacted earlier this year, by issuing implementing regulations, as well as by building capacity for effective supervision of the sector.

NEW LAW AND REGULATIONS

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¶13. Insurance companies in Armenia are regulated by the Law on Insurance and relevant CBA regulations. This new legislation was adopted in April 2007, and the CBA board member overseeing the sector told us it is in full compliance with European standards and directives. The previous law, adopted in 2004, had many shortcomings, including vague definitions of different insurance types, as well as no straightforward licensing and reporting requirements. Among other things, it also lacked mechanisms to regulate operation of the branches of foreign insurance companies in Armenia.

¶14. The new Law on Insurance has brought forth a number of innovations. First, it provides clear definitions of insurance and reinsurance activities consistent with European directives. The law specifies and clarifies procedures for issuing licenses, with separate approaches to different insurance types. It also separates life and non-life insurance activities, not allowing the same company to provide both life and non-life insurance services.

¶15. To further enhance the market, the CBA is currently working to establish a database for car accidents, which will later be extended to other categories as well. The CBA is also the licensing authority for actuaries under the insurance law, and plans are underway to provide basic actuarial training from March to December 2008, with more advanced training and the development of an actuarial association in Armenia to follow.

¶16. While the changes in the regulatory environment enforced by the CBA will most likely lead to the establishment of a stable, efficient, transparent and trustworthy market, and are generally positively perceived by local insurance companies, they also have their downsides. The rapid introduction and enforcement of the new requirements has created serious pressure on most companies in the market. In addition to the higher capital requirements, new financial reporting forms introduced by the CBA and more frequent reporting requirements are imposing a major administrative burden that smaller companies will be less likely to meet.

COMMENT

¶17. Increasing wealth should spur the development of Armenia's insurance market, as people come to appreciate the need to protect themselves against possible future calamities, and as the GOAM compels insurance coverage in matters of public interest. We are hopeful that recent legislative and regulatory changes will create a more transparent business environment that is welcoming to foreign investors. The consolidation of the sector, to the extent that it weeds out less reliable firms, is a positive development.

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